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MEMORANDUM OF LAW

DATE: September 2, 2009

TO: Honorable Mayor and City Councilmembers

FROM: City Attorney

SUBJECT: The Applicability of Charter Section 90.3 to a Proposed Civic Center Complex

INTRODUCTION

This office has been asked to analyze the applicability of City of San Diego Charter section 90.3, titled "Voter Approval for Major Public Projects Conferring Significant Private Benefit," to the Civic Center Complex as currently proposed by GED California, Incorporated [GED]. At this time the City has received a proposal that consists of various development options, but has yet to identify which option, if any, it may wish to pursue. Therefore, the following discussion is necessarily limited by the current description of the proposals. Some portions of the analysis could not be conducted at all, pending further decisions by the City. When further information is provided, or if the City negotiates an option that differs in a significant manner from those discussed herein, a new opinion may be warranted. For example, the development of a City Hall building only that would not confer a significant private benefit would not require a public vote.

QUESTIONS PRESENTED

Does approval of the proposed Civic Center Complex require a vote of the electorate pursuant to City of San Diego Charter section 90.3?

SHORT ANSWERS

It depends. Some factors in Charter section 90.3 are not yet final and analysis cannot occur without further decisions by the City.

BACKGROUND

On July 29, 2007, the Centre City Development Corporation [CCDC], on behalf of the City of San Diego, issued a Request for Qualifications for development teams interested in the opportunity to develop a new San Diego Civic Center Complex in partnership with the City. Eight responses were received and a selection committee chose two finalists to submit development proposals. The two finalists, GED and Hines were then invited to respond to the Request for Developer Proposals [RFP] for the San Diego Civic Center Complex, issued by CCDC on May 5, 2008. The RFP required that the response include a mixed use development including a City Hall, meet city and civic parking requirements, integrate with C Street, continue the use of the Civic Theatre or construct a new theater, incorporate "an extraordinary public plaza," comply with the City's Public Art program, and commit to a sustainable design and construction principles.

On December 20, 2007, the CCDC selection panel then selected GED as one of the top two developers[1] and on May 20, 2009, the CCDC Board recommended that the City enter into exclusive negotiations with GED. On June 10, 2009, the City Council Rules Committee voted to direct the Mayor to develop an Exclusive Negotiating Agreement [ENA] and present it to Council for review and approval, with specified conditions.

The understanding of the development proposals and financing discussed in this memorandum are based on the RFP, GED's Proposal, CCDC Reports to Rules Committee, dated May 20 and June 2, 2009, the CCDC PowerPoint slides presented at Rules Committee on June 10, 2009, and the actions of the Rules Committee. The proposals submitted by GED consist generally of variations in 1) the scale and potential uses of the development, which ranges from a four block mixed-use complex bounded by Third Avenue and A, C, and Front streets to the construction of only a City Hall building, and 2) the methods of financing. The development alternatives and financing discussed herein are those set forth in the June 10, 2008 CCDC presentation to the Rules Committee (Attachment 1). The development is proposed to occur in three phrases, which can be summarized as follows:[2]

> Phase One, on Block 14, consists of the development of the City Hall building which includes office and retail space, a separate building housing the Council Chambers, and parking. Phase Two consists of the construction of housing, retail, office space, and additional parking on Blocks 1 and 15. Phase Three consists of the construction of additional housing, retail, office space, and parking, and a fire station on Block 13. Therefore, Phases Two and Three consist mainly of private development, the exception being a new fire station as part of Phase Three.

[1] On August 15, 2008, Hines withdrew from the selection process.
[2] The specific development details of each phase are those set forth in the June 10, 2008 CCDC presentation to the Rules Committee (Attachment 2). Pg. 32 of CCDC presentation to Rules, June 10, 2008.

The difference between the financing alternatives presented for Phase One are basically whether to finance all or a portion of the building with tax-exempt bonds or to use taxable debt, followed by a tax-exempt Certificate of Deposit after 10 years, whether to retain 50 percent or 80 percent of the parking revenue, and whether to sell or lease surplus land, or neither.

ANALYSIS

City of San Diego Charter section 90.3, Voter Approval for Major Public Projects Conferring Significant Private Benefit, was approved as a charter amendment by the electorate on November 3, 1998. Section 90.3 prohibits the City from entering into any agreement for the financing, development, and construction of a major public project that confers a significant private benefit, unless that project is approved by a majority of those voting. Each development alternative for the Civic Center Complex must be analyzed to determine whether Charter section 90.3 requires a public vote.

I. Is the Financing, Development, and Construction of the Proposed Civic Center Complex a Major Public Project?

A major public project is defined as any capital improvement (excepting water, sewer, and other public infrastructure) for which the expenditure of City funds is proposed, and for which the City's total cost exceeds an amount equal to 10 percent of the City's General Fund budget for the fiscal year in which the electorate would vote on the project. San Diego Charter § 90.3(b)(1).

A. <u>Is This a "Capital Improvement"?</u>

San Diego Charter section 90.3 does not define "capital improvement." However, legislative enactments are to be construed "in accordance with the ordinary meaning of the language used and to assume that the legislature knew what it was saying and meant what it said." *Pacific Gas and Electric Company v. Shasta Dam Area Public Utility District*, 135 Cal. App. 2d 463, 468 (1955). In addition, "[t]he Legislature is presumed to be aware of other statutes on the same or analogous subject matter in which the same language is used" and therefore "it is not unreasonable to assume the Legislature meant the same thing when it used the same words . . . ." *Fernandez v. California Department of Pesticide Regulation*, 164 Cal. App. 4th 1214, 1230 (2008).

A common usage for "capital improvement" can be found throughout San Diego's Charter, Municipal Code, and Administrative Regulations. San Diego Charter section 77, Capital Outlay Fund, creates a fund for the purpose of capital outlay expenditures, i.e., "the acquisition, construction and completion of permanent public improvements, including public buildings and such initial furnishings, equipment, supplies, inventory and stock as will establish the public improvement as a going concern." San Diego Charter section 55.2 defines capital improvement for the purposes of that section to mean "physical assets, constructed or purchased, or the restoration of some aspect of a physical or natural asset that will increase its useful life by one year or more or which constitutes an environmental improvement of a natural asset." San Diego Charter § 55.2(a)(1).

San Diego Municipal Code section 61.2202, pertaining to the financing of public improvements in Facilities Benefit Areas, defines a capital improvement program as a plan for the implementation and financing of public facilities projects. Public facilities projects are then defined to include various types of public improvements: those necessary for the provision of utilities; streetlights; sidewalks; parks and recreational facilities; sewer and stormwater facilities; fire and flood protection infrastructure; land grading and surfacing; transportation; library, fire station, and school facilities; and traffic lights and signage.

City of San Diego Administrative Regulation 1.60 requires capital improvement program improvements to "have a useful life in excess of one year, extend the initial estimated useful life of the asset or increase usable capacity or improve functionality of the asset." San Diego Admin. Reg. 1.60 §1.2.

Therefore, a "capital improvement," as that term is used throughout the City, is essentially a physical improvement that is permanent in nature. The financing, development, and construction of the proposed Civic Center Complex under any of the development alternatives is a capital improvement pursuant to San Diego Charter section 90.3.

B. Is the Expenditure of City Funds Proposed?

City funds means "[those] funds authorized to be spent pursuant to an appropriation in the City's annual budget and derived through any type of financing mechanism, including cash, loans, revenue bonds, lease revenue bonds or certificates of participation, but not including funds generated by a financing mechanism in which the City acts solely as a conduit, and where all costs and financial risks associated with the financing, development and construction are the responsibility of individuals or entities other than the City." San Diego Charter § 90.3(b)(4).

The use of tax-exempt bonds for part or all of City Hall, or Phase One (Attachment 1, Alternatives A-F), may obligate the City to make payments sufficient to cover the portion of City Hall that it occupies, along with the associated parking (Attachment 3, Proposal pgs. F-2, F-3; F-6). The GED proposal suggests the utilization of a non-profit corporation to issue the tax-exempt and taxable debt, thereby shifting the financing risk to the private non-profit. This type of financing appears to fall within the exception set forth in San Diego Charter section 90.3(b)(4); "all costs and financial risks associated with the financing, development and construction are the responsibility of individuals or entities other than the City."

The use of taxable debt for the first 10 years, followed by the use of tax exempt Certificate of Participation (Alternative G) would require the City to make lease payments for the space used (Attachment 4, Proposal pg. F-4). The cash flow varies from $310,600,000 to $527,000,000 (Attachment 5, Proposal pg. F-9).

The determination of whether the costs to the City fall within the definition of "City funds" as set forth in the Charter may depend on the financing methods selected.

C. <u>If the Use of City Funds is Proposed, Does the City's Total Cost Exceed 10 Percent of the City's Expected General Fund Budget for Fiscal Years 2010 or 2011?</u>

The "cost[s]" mean the amount paid directly to develop or construct the project, and does not include costs related to financing or interest. San Diego Charter § 90.3(b)(2).[3]

For reference, the fiscal year 2010 general fund budget is $1,146,118,656. Ten percent of that budget is $114,611,865.60. The estimated development budget for just the office space portion of the City Hall building and its associated parking is estimated to be $432,372,042 (Attachment 6; CCDC PowerPoint, pg. 60). When the 2 percent developer fee of $7,388,096, which represents the "costs paid directly to develop or construct the project," is subtracted from this total, the budget is $424,983,946. The budget for the entire building, including the retail space and its associated parking is $439,829,922. When the 2 percent developer fee of $7,534,057 is subtracted, the total budget is $432,295,865.[4]

The estimated costs in each development proposal to construct just the City Hall building, with or without the retail space included in the estimate, exceed 10 percent of the current fiscal year's General Fund budget.

II. Does the Proposed Project Confer a Significant Private Benefit?

A significant private benefit "means that one or more identifiable private individuals or entities will have the exclusive use of any portion of the proposed capital improvement, pursuant to any type of agreement, for more than ten percent (10%) of the days during any calendar year that the proposed capital improvement is available for use, for the purpose of generating federal or state taxable income for such private individual or entity." San Diego Charter § 90.3(b)(3).

Councilmember DeMaio has asked whether lease of the excess space in the City Hall building to private companies, non-profits, or governmental agencies is considered a private benefit. The identity of the tenants of the excess space is not relevant to the analysis of whether a

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[3] For the purpose of the City making this analysis, it will be assumed that the Civic Center Complex proposes to use City funds, as defined in San Diego Charter section 90.3(b)(4).

[4] More recent evaluation by Jones Lang Lasalle of the City's net costs ranges from $338,507,393 to $399,597,199. *See*, Updated Financial Evaluation Briefing, Jones Lang Lasalle, May 19, 2009.

"significant private benefit" is conferred upon GED. Each development alternative includes an exclusive right to the use of space by GED, presumably for the purpose of generating taxable income.

A. Right to Exclusive Use.

Each proposal set forth in Attachment 1 would involve the right to exclusive use of some portion of the development by GED, an identifiable private entity. Even Phase One, with the least amount of private use, includes the private right to exclusive use of the retail space and associated parking. The RPF for the development included a requirement that the new City Hall provide the flexibility to expand the City use of the project as needed up to the year 2053, and that the City should only be expected to pay for the space it occupies. In response to this requirement, GED's proposal includes an obligation on their part to lease the excess City Hall space until such time as that space was needed by the City. Based on the City's needs forecast as determined by Gensler Architects, the City is not projected to need all of the excess expansion space for 50 years. This proposed use is more than 10 percent of the days during any calendar year that this proposed project is available for use.

B. Purpose of Generating Taxable Income.

It should be noted that GED is a corporation; corporations generally are understood to have a duty to their shareholders to maximize profits.[5] Corporate directors are required to act in the "best interests of the corporation and its shareholders . . . ."[6] A duty to maximize profits and to act in the best interests of the corporation and shareholders indicates an intent to generate taxable income.

The proposed project confers a significant private benefit within the meaning of San Diego Charter section 90.3.

CONCLUSION

Based on the RFP and the Response by GED, the current Civic Center Complex proposal anticipates the construction of a new City Hall and mixed use development over a four block site. This type of development qualifies as a capital improvement pursuant to San Diego Charter section 90.3. Whether the amount and type of City funding necessary for this improvement qualify as an expenditure of City funds that exceeds 10 percent of the City's General Fund will depend in part on the financing options chosen by the City. Each development alternative proposed includes some right to exclusive use by the developer, for the purpose of generating state or federal taxable income. That exclusive right, combined with the type of improvement

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[5] Ian B. Lee, *Corporate Law, Profit Maximization and the "Responsible Shareholder"*, University of Toronto (2005).

[6] Cal. Corp. Code § 309(a).

and the type and amount of necessary City expenditures may require that the approval of an agreement to finance, develop, and construct the Civic Center Complex be submitted to a vote of the electorate. The conclusions reached in this memorandum are based on the proposal as currently presented; additional analysis may be needed if a proposal is negotiated that differs significantly from those discussed herein.

JAN I. GOLDSMITH, City Attorney

By Shannon Thomas

Shannon Thomas
Deputy City Attorney

ST:pev
Attachments
ML-2009-13

San Diego Civic Center Complex

Gerding Edlen Alternatives

Alternative	Type of Financing	Surplus Land Sale or Lease	Full Development or Phase I Only	City Receive Phase I Parking Revenue?	Parkade Occupancy
GED 'A'	63-20 Tax-exempt Entire bldg.	Sale	Full	Yes	N/A
GED 'B'	63-20 Tax-exempt Entire bldg.	Lease	Full	Yes	N/A
GED 'C'	63-20 Tax-exempt Entire bldg.	N/A	Phase I Only	Yes	50%
GED 'D'	63-20 Tax-exempt Entire bldg.	N/A	Phase I Only	Yes	80%
GED 'E'	63-20 Partially Tax-exempt 660,000 SF	Sale	Full	No	N/A
GED 'F'	63-20 Partially Tax-exempt 660,000 SF	Lease	Full	No	N/A
GED 'G'	Taxable initial 10 years entire building; COP tax-exempt thereafter	Sale	Full	No	N/A

GED Proposed Development Program

	Phase One	Phase Two		Phase Three
	Block 14	Block 15	Block 13	Block 1
Site Area	Approx. 60,000 SF	Approx. 60,000 SF	Approx. 60,000 SF	Approx. 60,000 SF
Proposed FAR	17.1	9.5	11.0	14.0
Stories/Height	34 stories /456 ft.	23 stories /279 ft.	24 stories / 318 ft.	30 stories / 372 ft.
Retail Space	19,060 SF	46,475 SF	53,529 SF	21,977 SF
Office Space	984,756 SF	n/a	390,808 SF	375,514 SF
Type of Housing	n/a	Apartments	Apartments (or Hotel use)	Apartments
Number of Units / Residential or Hotel Space	n/a	245 / 317,710 SF	305 / 194,463 SF	415 / 394,834 SF
Affordable Housing	n/a	20%	20%	20%
Fire Station	n/a	n/a	n/a	34,000 SF
Parking Required	1,519 spaces	291 spaces	956 spaces	1,048 spaces
Parking Proposed	1,576 spaces	0	1,294 spaces	1,250 spaces

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OPTION I: 63-20 FULL

STRUCTURE: TAX-EXEMPT PRIVATE NON-PROFIT ON ENTIRE BUILDING

With this approach, a non-profit corporation will issue a tax-exempt and taxable debt under the Internal Revenue Service ruling 63-20 to fund the development and construction of the entire City Hall building and associated parking. Upon completion of the parking revenue, the City's rental payments and the master lease of the City's expansion space by the development team will cover the bond debt service. The Master Lease will be structured so that as the City will be able to move into this formerly private space as their own space needs grow. The biggest advantage to this option is that the City utilizes the lowest cost of capital for the entire City Hall building, and therefore the lowest possible occupancy cost. The development risk is shed to GED, and the ownership is simplified and streamlined.

Pros:

- City sheds development risk to GED
- City sheds financing risk to an established private non-profit
- City benefits from tax exempt construction and permanent financing
- Transaction likely to be off of the City's balance sheet
- City assured ownership upon debt retirement
- City is not exposed to inflation risk- bond debt service is established up-front
- Flexibility over scope and cost of improvements
- City has prepayment option to retire debt early
- Lowest overall 50 year occupancy cost, 46.4% less than the Staubach seven scenario average
- A single financing vehicle
- City owns the parking structure – dictates cost of parking and benefits from parking revenue growth

Con:

- Interest rate risk until bonds issuance

OPTION II: 63-20 @ 660,000 NSF

STRUCTURE: TAX EXEMPT PRIVATE NON-PROFIT ON CITY SPACE, COMMERCIAL FINANCING ON THE BALANCE OF THE BUILDING

This scenario utilizes both commercial and tax-exempt financing. Tax-exempt bonds will be used to fund the construction of the City's initial space requirement in 2013, approximately 660,000 NSF. The expansion space, the retail space and the entire parking garage will be classified as 'private program' and would be financed using commercial debt and equity. Since the public and private components are within one building, the building itself would be "condominiumized" to enable separate ownership. As space needs grow, the City can purchase additional condominiums of the privately programmed office space to meet their space demands.

Pros:

- City sheds development risk to GED
- City sheds financing risk to an established private non-profit
- GED pays for development rights of 'private program'
- City benefits from tax exempt construction and permanent financing
- Transaction likely to be off of the City's balance sheet
- Limited inflation risk on expansion space to City
- City retains some flexibility over scope and cost of improvements
- City assured ownership upon debt retirement
- City has prepayment option to retire debt early
- 39.7% lower overall occupancy cost over 50 years as compared to the Staubach seven scenario average

Alan
Occupation: Administrator
District: Rancho Penasquitos, District 1

"Try to balance practical needs and dollars with a place that people would really enjoy coming to and represents San Diego."

Cons:

- Interest rate risk until bond issuance
- More cumbersome condominium ownership structure
- Series of secondary financings necessary for expansion space
- Higher overall occupancy cost as compared to Option I
- GED owns the parking structure and dictates cost of parking

Joyce Evans
Occupation: Communications Coordinator
District: Otay Mesa, District 8

"This could really increase jobs for San Diego, which we need right now."

FINANCIAL STRUCTURE OF PHASE ONE - CITY HALL BUILDING

After examining the above options, we have decided to propose Option I: 63-20 Full as the ideal financing solution because it: 1) sheds the financing risk to the non-profit and GED, 2) allows for maximum flexibility and control of the City's space including expansion space, 3) results in the lowest occupancy cost and a 46.4% reduction in overall projected 50 year cost, 4) allows the City to have a high degree of control during the term of the debt, and 5) provides for the City to own the asset immediately upon repayment of the debt.

In the Option I: 63-20 Full, the non-profit corporation, SD Civic Center Properties, would enter into a Development Agreement with GED for the design and construction of the City Hall building. In addition, SD Civic Center Properties would enter into a long-term Lease Agreement with the City of San Diego, under which the City's rental payments would 1) commence solely upon the Developer's successful performance under the Development Agreement and 2) would be sufficient to pay the debt service on 63-20 Bonds issued by SD Civic Center Properties.

The Bonds will be a combination of tax-exempt debt, which will be used for that portion of the City Hall building and the associated parking that they occupy in 2013, and taxable debt, which will be used for that portion of the City Hall building Master Leased to the development team and held for the City's expansion needs and it's associated parking.

The City would bear financial responsibility for making payments on the portion of the City Hall building it occupies, the portion of the building that is Master Leased to GED, and the per stall parking revenue that is underwritten. The bond debt service, minus the GED's Master Lease rent and parking revenue, will net the City's effective 'rent' payments. The payment plan for the term of the bonds will be established up-front. Upon retirement of the SD Civic Properties Bonds, ownership of the building will transfer to the City without cost or encumbrances. This transfer is a federal requirement of 63-20 bonds. Furthermore, the City will be able to prepay its rental payments under the Lease to accelerate its acquisition of the City Hall Building.

OPTION III: COMMERCIAL FINANCING WITH CERTIFICATES OF PARTICIPATION (COP)

STRUCTURE: COMMERCIAL FINANCING FOR ENTIRE BUILDING, CITY BUYS BUILDING WITH COP AT YEAR 10

In this case, the entire City Hall building will be privately financed and constructed. Upon completion, the City will lease their portion of the City Hall building. The City will have the option to purchase the space after 10 years of operations. We have assumed that the City's purchase will be financed using Certificates of Participation. The COP take-out enables the City to access tax-exempt debt and 100% financing on their space. Upon retirement of the debt, the City will own the asset free and clear.

Pros:

- Simple build-to-suit / leaseback structure
- Purchase option included
- City sheds development risk to GED
- City sheds financing risk to GED
- GED pays for development rights of 'private program'
- 27.1% lower overall occupancy cost over 50 years as compared to the Staubach seven scenario average

Cons:

- Limited flexibility over total cost and scope of improvements
- Highest overall cost of occupancy
- City exposed to inflation risk
- Limited options for early purchase of building or retirement of debt
- GED owns the parking structure and dictates the cost of parking
- City owns building later in the 50 year term than Option I or II

CASH FLOW SUMMARY: OPTION I, II, III

The project pro-forma includes a detailed cash flow for each phase of the proposed development with line items for the public and private improvements clearly identified. The pro-forma also includes a separate cash flow for the proposed City Hall from inception to occupancy. The following charts summarize the cash flows for the three financing options. For more detailed information, please see the accompanying confidential disk with GED's project pro-forma.

OPTION I: 63-20 FULL (PREFERRED OPTION)

	BOND PROCEEDS	SENIOR DEBT	EQUITY	TOTAL COST	NOI	YIELD
PHASE ONE	$527,000,000	N/A	$13,900,000 (PRE-DEV ONLY)	[redacted]	$33,100,000	N/A
PHASE TWO	N/A	$240,400,000	$129,400,000	[redacted]	$27,000,000	7.32%
PHASE THREE	N/A	$201,900,000	$108,700,000	[redacted]	$22,000,000	7.07%

OPTION II: 63-20 @ 660,000 NSF

	BOND PROCEEDS	SENIOR DEBT	EQUITY	TOTAL COST	NOI	YIELD
PHASE ONE	$399,000,000	$75,000,000	$40,300,000	[redacted]	$34,200,000	8.10%
PHASE TWO	N/A	$240,400,000	$129,400,000	[redacted]	$27,000,000	7.32%
PHASE THREE	N/A	$201,900,000	$108,700,000	[redacted]	$22,000,000	7.07%

OPTION III: COMMERCIAL WITH CERTIFICATES OF PARTICIPATION (COP)

		SENIOR DEBT	EQUITY	TOTAL COST	NOI	YIELD
PHASE ONE	$221,000,000	$295,600,000	$159,100,000	[redacted]	$33,000,000	7.28%
PHASE TWO	N/A	$240,400,000	$129,400,000	[redacted]	$27,000,000	7.32%
PHASE THREE	N/A	$201,900,000	$108,700,000	[redacted]	$22,000,000	7.07%

Phase One Development Budget

	City Hall (including expansion space)	Retail
Studies and Entitlements	$10,664,351	$211,033
Demolition	10,355,415	204,585
Site Improvements and Parking	45,968,153	994,117
Shell and Core	177,515,104	2,954,300
Plaza / Open Space Improvements	10,287,165	96,682
Interior Improvements	46,183,920	930,120
Sustainability Contingency / Eco Roof	3,000,000	0
Furniture, Fixtures and Equipment	24,738,584	0
Voice / Data / Security	19,161,923	13,077
Public Art	2,995,726	25,498
Utility Upgrades / Temporary Cooling Towers	853,145	16,855
Signage	147,094	2,906
Permits and Fees	5,336,993	105,439
Architecture, Engineering and Other Professional Fees	12,186,444	567,856
Contingency and Cost Escalation	54,515,949	1,077,033
Developer Fee (2.0%)	7,383,096	145,961
Total Costs Before Financing	**$432,372,042**	**$7,457,880**

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